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# Post-Mortem Corporate Payments

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# POST-MORTEM CORPORATE PAYMENTS

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The taxation of payments by corporations to widows or other beneficiaries of deceased employees is the subject of this Article. In determining the tax treatment to be given these payments it is necessary to consider whether they are included in income, estate, and gift taxes, and whether the corporation may deduct them as business expenses. The treatment depends upon the nature of the post-mortem payment. Payments can be made either voluntarily or under a contractual obligation. Into the latter classification fall payments from group life insurance policies, distributions from qualified pension and profit-sharing plans, and payments made as distributions from nonqualified plans. In a given fact situation characteristics normally attributed to one type might be mixed with characteristics normally associated with one of the other types; but for the purpose of simplicity in describing the tax consequences of each of these types they will be treated as though they could be expected to occur as distinct entities. Relevant provisions of the Internal Revenue Code of 1954 will, of course, be the nexus of any tax consequences; also considered are rulings of the Internal Revenue Service and the case law.

## VOLUNTARY POST-MORTEM PAYMENTS

The major tax problem with regard to post-mortem payments which are made voluntarily is to determine the federal income tax consequences such payments have on the beneficiaries receiving them. The IRC excludes from gross income the first 5,000 dollars received by the estate or beneficiaries of the deceased employee if paid voluntarily or otherwise by or for an employer on account of the employee's death.[1] The Code does not provide an express rule for amounts over the 5,000 dollars.

### *Income or Gift*

If the excess is an amount received "by reason of the death of the employee," is it necessarily taxable under section 101(b), or does that section

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1. INT. REV. CODE OF 1954, § 101(b). Regardless of the number of employers making such payments, only an aggregate of $5,000 is excludable. Where payments on account of a deceased employee are divided among several beneficiaries, the exclusion must be prorated among the several beneficiaries in proportion to their respective percentages of the total payments. Treas. Reg. § 1.101-2(a)(3) (1957).

not apply to payments which are tax-exempt "gifts" within the meaning of section 102?[2] For several years after the enactment of the 1954 Code the IRS insisted that section 101(b) was intended to pre-empt the field of voluntary payments in respect of deceased employees, precluding treatment of these payments as gifts. Faced with the persuasive argument that the legislative history did not support this view,[3] in 1962 the IRS retreated from this extreme position, stoutly maintaining, nonetheless, that "widow's payments generally are not gifts."[4]

In 1960 *Commissioner v. Duberstein*[5] and two other cases[6] gave the Supreme Court an opportunity to attempt the formulation of a principle that would separate a gift, tax exempt under section 102 of the Code, from a distribution in the nature of compensation which would be taxable.[7] The Court declined, refusing to "satisfy an academic desire for tidiness, symmetry and precision in this area,"[8] saying that "the governing principles are necessarily general and have already been spelled out in the opinions of this Court."[9] *Duberstein* did decide that "the statute does not use the term 'gift' in the common-law sense,"[10] and that "the question here remains basically one of fact, for determination on a case-by-case basis. One consequence of this is that appellate review of determinations in this field must be quite restricted."[11]

The Court stated that a payment could not be a gift if it proceeded from the constraining forces of any moral or legal duty or from the incentive of anticipated benefit. "Conversely, where the payment is in return for services rendered, it is irrelevant that the donor derives no economic benefit from it." "A gift in the statutory sense . . . proceeds from a 'detached and disinterested generosity' . . . out of affection, respect, admiration,

2. INT. REV. CODE OF 1954, § 102(a): "Gross income does not include the value of property acquired by gift, bequest, devise, or inheritance."

3. Crown, *Payments to Corporate Executives' Wives*, N.Y.U. 19TH INST. ON FED. TAX 815 (1961). See generally *Payments to Widows*, 49 VA. L. REV. 74, 77-90 (1963).

4. Rev. Rul. 62-102, 1962 INT. REV. BULL. No. 28, at 7, *modifying* Rev. Rul. 60-326, 1960-2 CUM. BULL. 32.

5. 363 U.S. 278 (1960).

6. Stanton v. United States, 363 U.S. 278; United States v. Kaiser, 363 U.S. 299. For an excellent discussion of all three cases see Note 49 VA. L. REV. 74 (1963).

7. These cases did not involve employee death benefits; but they did deal with the tax status of nonobligatory business gratuities. *Duberstein* involved a gift of a Cadillac to a business acquaintance, *Stanton* a noncontractual employee separation payment, and *Kaiser* a voluntary support payment by a union to a nonmember striker.

8. Commissioner v. Duberstein, 363 U.S. at 290.

9. *Id.* at 284.

10. *Id.* at 285.

11. *Id.* at 290. This represented a departure from the Court's earlier view in Bogardus v. Commissioner, 302 U.S. 34 (1937) in which the gift issue was treated as a question of law.

charity or like impulses."[12] The test, concluded the Court, was this: what was the dominant reason for the transfer?[13] The Commissioner contended that

> payments by an employer to an employee, even though voluntary, ought, by and large, to be taxable; that the concept of a gift is inconsistent with a payment's being a deductible business expense; that a gift involves personal elements; that a business corporation cannot properly make a gift of its assets.[14]

The Court generally agreed with the Commissioner's propositions, but did not view them as principles of law; rather they were "maxims of experience that the tribunals which have tried the facts of cases in this area have enunciated."[15]

The *Duberstein* case does not specify in what situations a moral duty to make a payment exists. The question of whether there is a moral duty to provide for the wife and children of a deceased employee so as to disqualify the payment from gift treatment is still unanswered. Although the Tax Court has suggested that provision for a needy widow may in some circumstances qualify as a gift, that court has not yet found such circumstances present in a case.[16] Whether the "anticipated benefit" to an employer of good relations with his employees is an economic benefit that would disqualify a payment to an employee's widow from gift treatment is also uncertain.[17] A voluntary payment made to the family of a deceased employee principally in tribute to the deceased for his contribution to the business and only secondarily as a token of sympathy for the bereaved family would probably be a "payment in return for services rendered," not qualifying as a gift. The Court of Appeals for the Third Circuit has affirmed a Tax Court decision precluding payments from gift classification where the primary reason for payments to the widow was gratitude for services rendered by her deceased husband.[18]

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12. 363 U.S. at 285.
13. *Id.* at 286.
14. *Id.* at 287.
15. *Ibid.*
16. In Cunning v. United States, 62-2 U.S. Tax Cas. ¶ 9503 (N.D. Tex. 1962) evidence that a widow was in need influenced the court to find a gift. But in Margaret H.D. Penick, 37 T.C. 999 (1962) evidence that the widow was an arthritic cripple did not melt the Tax Court's heart, because she had an income substantially in excess of her medical expenses, and in Olsen's Estate v. Commissioner, 302 F.2d 671, 674 (9th Cir. 1963) the court flatly stated that there was no "moral obligation" to provide for the widow of a deceased employee who had already been fully compensated.
17. In Gaugler v. United States, 204 F. Supp. 493 (S.D.N.Y. 1962) the court thought this type of anticipated benefit would disqualify the payment as a gift. There was testimony to the effect that failure to make the payments would have had an adverse effect on the reputation of the employer in Wall Street.
18. Smith v. Commissioner, 305 F.2d 788 (3d Cir.), *cert. denied*, 371 U.S. 904 (1962). See in this connection Martin v. Commissioner, 305 F.2d 290 (3d Cir.), *cert.*

Some question may exist as to whether a *corporate* employer can be motivated by "detached and disinterested generosity." The Tenth Circuit Court of Appeals in *Joshel v. Commissioner*[19] conceded that "these are personal emotions to which a corporation is not subjected," but held, contrary to the Tax Court, that the personal-emotions test of *Duberstein* did not apply to a corporation.[20]

When the employer deducts his payment to a widow as a business expense, has he acted inconsistently with a dominant intent to make a gift? In *Duberstein* deduction of the payment was thought to be a relevant factor, but the Court pointed out that the Code did not correlate deductibility by the corporation with taxability to the beneficiary.[21] Circuit court decisions have tended to discount the fact that the payment was deducted as a business expense by the employer on the theory that the status of the payment for the recipient should not depend on how the payor labels it.[22]

At least ten factors seem to play a noticeable part in winning gift treatment for voluntary payments made by corporations to beneficiaries of deceased employees.[23] Unfortunately, even where all ten of these factors

*denied*, 371 U.S. 904 (1962); Gaugler v. United States, *supra* note 17; Hein v. United States, 62-2 U.S. Tax Cas. ¶ 9564 (E.D. Wis. 1962).

19. 296 F.2d 645, 647 (1961).

20. *But see* United States v. Kasynski, 284 F.2d 143, 146 (10th Cir. 1960). Here the Commissioner's contention that a corporation may not have the "personalized feelings" necessary for a gift under the Commissioner's view of *Duberstein* was rejected.

21. 363 U.S. at 286.

22. Kuntz Estate v. Commissioner, 300 F.2d 849, 851 (6th Cir. 1962); Olsen's Estate v. Commissioner, 305 F.2d 671, 674 (8th Cir. 1962).

23. The ten factors are as follows:

(1) The absence of any legal or moral obligation to make such payments, the deceased employee having received all remuneration due him.

(2) The absence of an established policy of making such payments. See Gaugler v. United States, 204 F. Supp. 493 (S.D.N.Y. 1962).

(3) The presence of financial need on the part of the widow or other family members receiving the death benefits.

(4) The absence of a relationship between the amounts paid and the deceased employee's salary. Estate of Julius B. Cronheim, 20 CCH Tax Ct. Mem. 1144 (1961).

(5) The reasonableness of the payments in amount and duration—they should be proportionate to a widow's need, for example.

(6) The absence of any direct or indirect economic benefit to the corporation resulting from the payments.

(7) The presence of a corporate resolution and supporting facts which stress the personal motivations, such as esteem for the deceased employee, sorrow at his passing, sympathy for his family and intent to provide for their needs as the deceased would have provided for them, had he lived, and which omit any suggestion that the payments are in return for, or even in recognition of, valuable services rendered by the deceased.

(8) The absence of any stockholder, director, or employee relationship between the individuals receiving such payments and the payor corporation.

(9) The absence of any attempt by the corporate employer to withhold taxes upon the payments, as was the case in Roy I. Martin, 36 T.C. 556 (1961), or to deduct them from corporate income under headings so out of harmony with donative intent as "compensation to officers," as in Frankel v. United States, 192 F. Supp. 776 (D. Minn.

combine, it cannot be predicted with confidence that the bereaved widow will reach her tax-exempt gift sanctuary without litigation.

Considerable confusion has developed in this area between the IRS, the Tax Court, and the federal circuit and district courts.[24] Since *Duberstein* there have been no Tax Court cases decided in favor of the taxpayer which involved employee death benefits.[25] Prior to the Supreme Court decision, an almost unbroken line of Tax Court cases held for the taxpayer.[26] The turnabout is a remarkable one, particularly when viewed in light of the pronouncement in *Duberstein* that "the governing principles . . . have already been spelled out in the opinions of this Court."[27] Other than the Tax Court,

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1961) or "administration expenses," as in Wilner v. United States, 195 F. Supp. 786 (S.D.N.Y. 1961) or "business expenses," as in Estate of Louis Rosen, 21 CCH Tax Ct. Mem. 316 (1962).

(10) The payment of the benefits to the widow or family of the deceased rather than to his estate. Brayton v. Welch, 39 F. Supp. 537 (D. Mass. 1941); Estate of Edward Bausch, 14 T.C. 1433 (1950). *Contra*, Estate of Frank v. Foote, 28 T.C. 547 (1957).

24. See, *e.g.*, Cowan v. United States, 191 F. Supp. 703 (N.D. Ga. 1960). The court, swayed by the sympathetic tenor of the corporate resolution, found the payments to be a gift to the widow, even though made "in recognition of Mr. Cowan's invaluable services to the company." Recently the federal circuit court of appeals in Philadelphia and the federal district courts in Wisconsin, New York, Maryland, and Massachusetts have found similar payments to be taxable income and not tax free gifts. Martin v. Commissioner, 62-2 U.S. Tax Cas. ¶ 9575 (3d Cir. 1962); Smith v. Commissioner, 62-2 U.S. Tax Cas. ¶ 9574 (3d Cir. 1962); Brown v. United States, 63-2 U.S. Tax Cas. ¶ 9696 (D. Mass. 1963); Froehlinger v. United States, 63-1 U.S. Tax Cas. ¶ 9492 (D. Md. 1963); Hein v. United States, 62-2 U.S. Tax Cas. ¶ 9564 (E.D. Wis. 1962); Gaugler v. United States, 62-1 U.S. Tax Cas. ¶ 9439 (S.D.N.Y. 1962).

25. See Smith v. Commissioner, 305 F.2d 778 (3d Cir. 1962); Waters v. Commissioner, 36 P-H Tax Ct. Mem. 252 (1963); Doumahes v. Commissioner, 36 P-H Tax Ct. Mem. 249 (1963); Oppenheimer Casing Co. v. Commissioner, 22 CCH Ct. Mem. 1082 (1963); Margaret H.D. Penick, 37 T.C. 999 (1962); Estate of Louis Rosen, 21 CCH Tax Ct. Mem. 316 (1962); Mary C. Westphal, 37 T.C. 340 (1961); Roy I. Martin, 36 T.C. 556 (1961); Estate of Julius B. Cronheim, 20 CCH Tax Ct. Mem. 1144 (1961); Estate of W.R. Olsen, 20 CCH Tax Ct. Mem. 807 (1961); Estate of Irving B. Cooper, 20 CCH Tax Ct. Mem. 774 (1961); Mary T. Fischer, 20 CCH Tax Ct. Mem. 318 (1961); Estate of Rose A. Russek, 20 CCH Tax Ct. Mem. 123 (1961); Estate of Mervin G. Pierpont, 35 T.C. 65 (1960), *rev'd sub nom.* Poyner v. Commissioner, 301 F.2d 287 (4th Cir. 1962); Ivan Y. Nickerson, 19 CCH Tax Ct. Mem. 1508 (1960); Estate of Martin Kuntz, Sr., 19 CCH Tax Ct. Mem. 1379 (1960), *rev'd sub nom.* Estate of Kuntz v. Commissioner, 300 F.2d 849 (6th Cir. 1962); Abe A. Danish, 19 CCH Tax Ct. Mem. 1349 (1960).

In Oppenheimer, *supra*, it was the Commissioner who contended that the benefits paid constituted a gift—the Tax Court still held that the payments were compensation.

26. Florence S. Luntz, 29 T.C. 647 (1958). Estate of Albert W. Morse, 17 CCH Tax Ct. Mem. 261 (1958); Standard Asbestos Mfg. & Insulating Co., 17 CCH Tax Ct. Mem. 207 (1958); Estate of John A. Mayconn, Sr., 29 T.C. 81 (1957); Louis K. Aprill, 13 T.C. 707 (1949). The sole case in which a taxpayer was defeated was Estate of Charles J. Ginsberg, 17 CCH Tax Ct. Mem. 472 (1951).

27. 363 U.S. at 284. Mr. Justice Frankfurter commented about this in his concurring opinion:

> What the Court now does sets factfinding bodies to sail on an illimitable ocean of individual beliefs and experiences. . . . I am afraid that by these new phras-

however, the federal courts have concluded that what was considered to be a gift before *Duberstein* should continue to be so regarded thereafter.[28] In the face of this conflict in the lower federal courts, the Supreme Court recently denied certiorari to four key cases.[29] Mr. Justice Frankfurter's warning of cases decided in "an illimitable ocean of individual beliefs and experiences"[30] comes to mind.

*The Employer's Business Expense Deduction*

The Treasury Regulations under the Internal Revenue Code of 1939 provided that amounts paid for a limited period as pensions or continuations of salary in recognition of past services to families or dependents of deceased employees were deductible as ordinary and necessary business expenses.[31] The rule applied though the payments were purely voluntary.[32] No comparable provision appears in the Regulations for the 1954 Code, but the omission was not thought to represent a change in the attitude of the IRS.[33] In fact a 1939 Revenue Ruling[34] to the effect that a *gift* may be deductible under proper circumstances was relied upon in some private rulings issued in 1959.[35] The new IRS tactic of disallowing both the business expense

ings the practicalities of tax administration which should be as uniform as is possible in so vast a country as ours, will be embarrassed. *Id.* at 296-97.

28. See Estate of Olsen v. Commissioner, 302 F.2d 671 (8th Cir.), *cert. denied*, 371 U.S. 903 (1962); Poyner v. Commissioner, 301 F.2d 287 (4th Cir. 1962). In United States v. Kasynski, 284 F.2d 143 (10th Cir. 1960) the widow's previous salary as a secretary was discontinued pending payment to her of a monthly stipend "in recognition of her husband's services." Rice v. United States, 197 F. Supp. 223 (E.D. Wis. 1961) held that voluntary payments to a widow-director in excess of $30,000 were gifts, although they were deducted as salary allowances. It was held in Frankel v. United States, 192 F. Supp. 776 (D. Minn. 1961), *aff'd*, United States v. Frankel, 302 F.2d 666 (8th Cir.), *cert. denied*, 371 U.S. 903 (1962) that payments to a widow consisting of the bonus and salary her husband would have received if he had lived, and a company car, were gifts although they were deducted as compensation. And see Cowan v. United States, 191 F. Supp. 703 (N.D. Ga. 1960); Paxton v. United States, 62-2 U.S. Tax Cas. ¶ 9686 (S.D. Ala. 1962) (payments held gift although corporation later disclaimed donative intent); Schwartz v. United States, 62-2 U.S. Tax Cas. ¶ 9661 (N.D. Tex. 1962); Palmer v. Mathis, 62-2 U.S. Tax Cas. ¶ 9636 (E.D. Ark. 1962); Cunning v. United States, 62-2 U.S. Tax Cas. ¶ 9593 (N.D. Tex. 1962).

29. Smith v. Commissioner, 305 F.2d 778 (3d Cir.), *cert. denied*, 371 U.S. 904 (1962); Estate of Olsen v. Commissioner, *supra* note 28; Frankel v. United States, *supra* note 28; Estate of Kuntz v. Commissioner, 300 F.2d 849 (6th Cir. 1962).

30. Commissioner v. Duberstein, 363 U.S. at 284 (concurring opinion).

31. Treas. Reg. 118, § 39.23(b)-9 (1953).

32. Rev. Rul. 54-625, 1954-2 CUM. BULL.

33. It has been suggested that the omission merely reflects a belief on the Treasury's part that the deduction should be taken as deferred compensation under § 404. Diehl, *Payment to Widows of Corporate Employees*, U. So. CAL. 1960 TAX INST. 491. This view, however, was rejected in Champion Spark Plug Co., 30 T.C. 295 (1958). Although the Treasury refused to acquiesce in this decision, 1958-2 CUM. BULL. 9, it was affirmed. Commissioner v. Champion Spark Plug Co., 266 F.2d 347 (6th Cir. 1959).

34. I.T. 3329, 1939-2 CUM. BULL. 153.

35. 4 MERTENS, FEDERAL INCOME TAXATION § 25.67, at 218 (1960).

deduction and the section 102 gift exclusion, creating a conflict between the payor and the payee may signal a change of position on the entire question of deductibility.[36] The Commissioner has long argued that the taking of a business-expense deduction is irreconcilable with a donative intent. That the Supreme Court in *Duberstein* accepted this proposition as one of the "maxims of experience"[37] may play a role in determining its treatment in the future.

A few recent Tax Court cases involved a determination of whether post-mortem corporate payments were deductible as business expenses. The deduction was denied for a payment made in gratitude for a president's outstanding services, because no business purpose was found to exist.[38] In two cases widows were held to have received dividends rather than death benefits.[39] Two other Tax Court cases allowed the deduction;[40] in one of them the court said the payments were neither gifts nor dividends.[41]

### *Gift Tax Consequences to the Employer*

Should the death-benefit payment constitute a gift, gift tax liability would seem to follow inevitably, assuming payments in excess of available exclusions and exemptions; however, the federal gift tax is a levy upon individuals only,[42] and not upon corporations.[43] The Regulations cope with this problem by treating a gift by a corporation as a gift by its stockholders.[44] Presumably, the gift of each stockholder would be proportionate to his percentage interest in the stock of the company.

### *Liability of Decedent's Estate*

If the death benefit qualifies as a gift under section 102, it is not includable in the deceased employee's gross estate for federal estate tax purposes. The gift never vested as a property right in the decedent or came into existence as a property right in anyone until after his death. The payment must be purely discretionary on the part of the employer. A payment enforceable by the decedent as a customary bonus is included in his gross

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36. See Estate of Louis Rosen, 21 CCH Tax Ct. Mem. 316 (1962); Pelisek, *Tax Treatment of Widows*, 45 MARQ. L. REV. 366, 374 (1961).
37. 363 U.S. at 287.
38. Interstate Drop Forge Co., 22 CCH Tax Ct. Mem. 701 (1963).
39. Schner-Block Co., 22 CCH Tax Ct. Mem. 796 (1963); Rubber Associates, Inc., 22 CCH Tax Ct. Mem. 576 (1963).
40. Oppenheimer Casting Co., 22 CCH Tax Ct. Mem. 1082 (1963); J. Aron & Co., 22 CCH Tax Ct. Mem. 788 (1963).
41. Oppenheimer Casting Co., *supra* note 40.
42. INT. REV. CODE OF 1954, § 2501.
43. Treas. Reg. § 25.0-1(b) (1958).
44. Treas. Reg. § 25.2511-1(b)(1) (1958).

estate.[45] The same principle obtained in the case of an established policy in favor of paying stated death benefits.[46]

## GROUP LIFE INSURANCE

The preceding portion of this Article discussed the tax consequences of payments made voluntarily by corporations; attention will now be directed to post-mortem payments which are not voluntary in nature. The proceeds of group life insurance policies will be the first type of payments considered. Group insurance can be divided into three categories, group term, group permanent, and a mixture of term and permanent. The tax consequences of each may differ somewhat.

### *Inclusion in Decedent's Estate*

All insurance proceeds payable to the decedent's estate, whether from group plans or otherwise, are part of his gross estate for federal estate tax purposes.[47] This is true even though the decedent was not the policy owner, could not designate his estate the insurance beneficiary, and possessed no incidents of ownership in the insurance at the time of his death. Even if the estate is not named beneficiary, insurance proceeds will be considered payable to the estate if they are legally bound for the payment of charges which would otherwise be enforceable against the executor, as when the insurance has been pledged as collateral for a loan to the decedent.[48]

Insurance payable to a beneficiary other than the insured's estate is included in his estate for estate tax purposes if the insured possessed an incident of ownership in the insurance policy at the time of his death.[49] "Incident of ownership" is a comprehensive term denoting any economic benefit under the policy.[50] Rights to cancel, surrender, assign, or pledge the policy, or change beneficiaries under the policy, are incidents of ownership. Under the normal group life insurance policy, the insured has the right to designate and change beneficiaries.

45. Estate of A.B. King, 20 T.C. 930 (1954); Estate of P.G. Leoni, P-H Tax Ct. Mem. 678 (1948); Estate of L.B. McKitterick, 42 B.T.A. 130 (2d Cir. 1942).

46. G.C.M. 27242, 1952-1 CUM. BULL. 160.

47. INT. REV. CODE OF 1954, § 2042(1). The exemption of payments from a qualified pension or profit-sharing plan does not apply to amounts receivable by executors. INT. REV. CODE OF 1954, § 2039(c).

48. Treas. Reg. § 20.2042-1(b)(1) (1958). Insurance may not be considered payable to an estate although paid to an executor if under state law the proceeds are not administered and distributed as a part of the decedent's estate subject to creditor's claims, but pass to the exclusive benefit of the widow and children. LOWENDES & KRAMER, FEDERAL ESTATE AND GIFT TAXES 278-79 (2d ed. 1962).

49. INT. REV. CODE OF 1954, § 2042(2). An exemption has been provided, however, for proceeds of policies purchased by the trustee of a noncontributory pension or profit-sharing plan payable to beneficiaries other than the insured's estate.

50. Treas. Reg. § 20.2042-1(c)(2) (1958).

The mere fact that the beneficiary was selected by the deceased employee would not automatically render the insurance proceeds includable in the employee's gross estate if he did not continue to possess incidents of ownership up to the time of his death. It would be difficult, however, for an employee to assign a group term life insurance policy so as to divest himself of all incidents of ownership therein. The master group contract ordinarily prohibits assignment of the policy. Furthermore, most states have laws requiring that the employee be given a conversion privilege to exercise on termination of his employment. Thus, the employee would probably continue to possess an incident of ownership, because upon quitting his job he could effect a conversion of the policy by acting in conjunction with the assignee.

Any irrevocable designation of beneficiary by an insured, especially under a group term policy which is normally renewable annually, is likely to constitute a transfer in contemplation of death.[51] Even if the designation is made more than three years prior to the employee's death, the continued payment of premiums could be treated by the Commissioner as though made by the employee, "as a matter of tax substance."[52]

Although an insured employee is entitled to designate the beneficiary under his group insurance, the proceeds are not included in his gross estate if their payment or continuation of the insurance was dependent upon the discretion of the employer. Unless the employee has an unqualified right in the insurance, either alone or in conjunction with another person, he would not possess an incident of ownership[53] or own an interest in property passing at death.[54] In *Dimock v. Corwin*[55] an employee was considered not to have a taxable interest in death benefits payable to his widow, because the employer reserved the right to cancel payment at any time prior to the employee's death. The Commissioner had ruled in 1937 that forfeitable benefits were not taxable.[56] In 1952 this ruling was revoked, and the position taken that where an employee has the power to designate a beneficiary, he is in possession of rights under a plan which constitute property passing at his death.[57] While the *Dimock* case has been followed in the majority of decisions in this area,[58] occasional decisions have held that under the par-

51. Treas. Reg. § 20.2035-1 (1958).

52. With respect to group-term life insurance, as distinguished from group-permanent life insurance, the Commissioner is also likely to take the position that the entire proceeds of the policy are includable and not merely the proportionate amount attributable to payment of the last three years' premiums. *Cf.* Commercial Nat'l Bank & Trust Co. v. Johnson, 123 F. Supp. 728 (S.D.N.Y. 1954).

53. See INT. REV. CODE OF 1954, § 2042(2).

54. See INT. REV. CODE OF 1954, § 2033.

55. 19 F. Supp. 56 (E.D.N.Y. 1937), *aff'd on other grounds*, 99 F.2d 799 (2d Cir. 1938), 306 U.S. 363 (1939).

56. G.C.M. 17817, 1937-1 CUM. BULL. 281.

57. G.C.B. 27242, 1952-1 CUM. BULL. 160.

58. *E.g.*, Estate of William E. Barr, 40 T.C. No. 27 (May 3, 1963).

ticular plans involved the employees' rights became sufficiently fixed to constitute enforceable obligations though subject to forfeiture if the employees terminated their employment or were discharged for cause.[59]

*Income Tax Consequences of Group Insurance*

The employee's income tax consequences with respect to the premiums paid for group insurance are to a great extent dependent upon the type of insurance at hand. Premiums paid by an employer for group-term life insurance and split-dollar plan insurance are not taxable to the employee even if he has a right to designate the beneficiary.[60] The proposed Revenue Bill of 1963 would limit this rule to the cost of 30,000 dollars protection for any one individual.[61] Premiums paid by an employer on group permanent life insurance are taxable income to the employee if his rights in the insurance are nonforfeitable. If permanent and term are mixed the premiums are taxable to the employee proportionately to the extent of his permanent coverage.[62] If group-permanent life insurance is forfeitable, for example when the corporation retains the right to designate the beneficiary, the insurance premiums do not constitute taxable income to the beneficiary;[63] the employee would be taxed only on the value of any nonforfeitable rights he might have received under the contract.

If group-permanent life insurance is part of a qualified plan and proceeds of the policy are payable to a beneficiary named by the employee, then the proceeds are taxable to the beneficiary as income, because they are not includable in the decedent's gross estate. If the premiums on this insurance were partly paid by the employee, or if he was taxable on a portion of them, proper adjustments would be required to reflect that amount which would not be taxable.[64] Capital gains treatment for lump-sum payments,[65] the 1,000 dollar surviving spouse exclusion,[66] and the 5,000 dollar death-benefit exclusion[67] are also available for adjustment purposes.

59. Rosenberg v. United States, 309 F.2d 724 (7th Cir. 1962); Charleston Nat'l Bank v. United States, 63-2 U.S. Tax Cas. ¶ 12, 161 (S.D.W. Va. 1963); see cases collected in LOWENDES & KRAMER, *op. cit. supra* note 48, at 26-7 n.11.

60. Treas. Reg. § 1.61-2(d)(2) (1957), as amended, T.D. 6416, 1959-2 CUM. BULL. 126; Rev. Rul. 56-400, 1956-2 CUM. BULL. 116. But premiums paid by a trustee on group-term life insurance are currently taxable to the employees. Rev. Rul. 54-52, 1954-1 CUM. BULL. 150.

61. H.R. 8363, 87 Cong., 1st Sess. (1963).

62. Mim. 6477, 1950-1 CUM. BULL. 16. Under a contributory plan the employees' income taxes on the funds can be reduced by a stipulation that the employees' contributions are to be applied first against the cost of the permanent life insurance.

63. Treas. Reg. § 1.61-2(d)(2); Mim. 6477, 1950-1 CUM. BULL. 16.

64. Treas. Reg. § 1.72-8 (1956).

65. Treas. Reg. § 1.403(a) (1956).

66. INT. REV. CODE OF 1954, § 101(d)(1)(B).

67. INT. REV. CODE OF 1954, § 101(b)(2).

*The Employer's Deduction for Premiums*

An employer is entitled to deduct as an ordinary and necessary business expense the cost of group-term life insurance on employees and salesmen.[68] The deduction is not allowed if the employer is directly or indirectly a beneficiary under the policies.[69] Thus, where group-term life insurance is used to fund a shareholder's buy-sell agreement, a private-letter ruling states that the premium is not deductible.[70] If insurance coverage for shareholder employees is disproportionately large, payment of the premiums might be treated as a nondeductible dividend from the corporation.

Premiums paid on group-permanent life insurance payable to employees' personal beneficiaries are deductible only if the right to the insurance is nonforfeitable when the premiums are paid.[71] If the employee's rights in the insurance are then forfeitable, the employer is not allowed a deduction at any time.

Normally, it can be seen, the corporation has the right to deduct premiums on group life insurance as a business expense when the employee has the right to name the beneficiary.[72] If the corporation retains the right to designate the beneficiary, the payments are not deductible by the corporation, which can be considered a beneficiary under the policies.[73]

*Gift Tax Consequences*

Unless the insured employee makes an irrevocable beneficiary designation and divests himself of all reversionary interests and power to control the economic benefits of his policy[74] (extremely unlikely under a group life insurance contract), the federal gift tax is not applicable to him. The corporation's gift tax liability, however, is not entirely free from doubt.[75]

## QUALIFIED PENSION AND PROFIT-SHARING PLANS

For tax purposes there are two classifications of pension and profit-sharing plans, qualified[76] and nonqualified. Tax consequences of payments under the plans differ according to the type of plan under which payments

68. Rev. Rul. 56-400, 1956-2 CUM. BULL. 116; Rev. Rul. 54-165, 1954-1 CUM. BULL. 17.
69. Treas. Reg. § 1.264-1 (1957).
70. 7 CCH 1962 STAND. FED. TAX REP. ¶ 6496.
71. See INT. REV. CODE OF 1954, § 404(a)(5).
72. Treas. Reg. § 1.72-8 (1956), as amended, T.D. 6665, 1963-32 INT. REV. BULL. 7.
73. See Treas. Reg. § 1.264-1 (1957); Private Letter Ruling, 7 CCH 1962 STAND. FED. TAX REP. ¶ 6496.
74. Treas. Reg. § 25.2511-1(h), Example (8) (1958).
75. See INT. REV. CODE OF 1954, § 2501(a). *But see* Treas. Reg. § 25.2511-1(h)1 (1958).
76. § 401 of the INT. REV. CODE OF 1954 states which plans are qualified.

are made. The consequences with respect to qualified plans will be considered first.

*Decedent's Gross Estate*

The estate tax was often imposed on distributions from qualified plans under the Internal Revenue Code of 1939.[77] The 1954 Code provides, however, that a deceased employee's gross estate does not include the value of annuities or other benefits payable to a beneficiary, other than the decedent's executor, under qualified pension and profit-sharing plans.[78] In the event payment is made to the executor, the entire amount is included in the decedent's gross estate. A payment of the joint-and-survivor variety made upon the death of the employee is excluded from his gross estate by the Regulations.[79] The Treasury has adopted a similar rule for the case of a lump-sum distribution to a designated beneficiary upon the employee's death prior to his retirement.[80]

An employee might make an election under a qualified plan to have the benefits credited to him, with interest payable to him for life, and the principal payable to a named beneficiary or to himself if the employee later desires to take it. Here the doctrine of constructive receipt applies; the payment would not be considered payable under the plan, and the section 2039 exclusion would not be applicable.[81]

Nor does the exclusion apply to any portion of the benefits which are attributable to contributions made by the employee under a contributory or thrift plan. In this situation the amount excluded is that amount which bears the same ratio to the value of the payment to the beneficiary as the employer's contribution to the coverage bears to the total cost of the employee's protection.[82] When the employer's contribution cannot be readily ascertained, the Regulations provide that the total contributions shall be the value of the annuity or other amount payable, as of the time the decedent's rights first mature; from this amount is subtracted the amount of the employee's contribution, and the balance represents the employer's contribution.[83]

77. Pierce Rosenberg v. United States, 62-2 U.S. Tax Cas. ¶ 12,119 (7th Cir. 1962); Estate of Garber v. Commissioner, 271 F.2d 97 (3d Cir. 1959); Sample v. United States, 61-1 U.S. Tax Cas. ¶ 12004 (W.D. Pa. 1961).

78. INT. REV. CODE OF 1954, § 2039(c).

79. Treas. Reg. § 20.2039-2(b)(3), Example (1) (1958), as amended, T.D. 6666, 1963-32 INT. REV. BULL. 22.

80. Treas. Reg. § 20.2039-2(b)(3), Example (2) (1958), as amended, T.D. 6666, 1963-32 INT. REV. BULL. 22.

81. Treas. Reg. § 20.2039-2(b)(3), Example (4) (1958), as amended, T.D. 6666, 1963-32 INT. REV. BULL. 22.

82. Treas. Reg. § 20.2039-2(c)(1) (1958), as amended, T.D. 6666, 1963-32 INT. REV. BULL. 22.

83. Treas. Reg. § 20.2039-2(c)(2) (1958), as amended, T.D. 6666, 1963-32 INT. REV. BULL. 22.

In 1962 section 2039 of the Code was amended to deny the exclusion to self-employed individuals. Contributions made on behalf of a person with net earnings from self-employment are considered contributions made by him as an employee, and the entire amount payable under the plan is includable in his gross estate.[84]

*Income Tax Liability of Recipients*

Distributions from qualified pension and profit-sharing plans are considered taxable income, and are taxed to the recipients in accordance with sections 402 and 403 of the Internal Revenue Code of 1954. The effect of these sections is that such distributions are taxed as annuities under section 72[85] unless the total distribution is paid within one taxable year of the distributee in which case a special rule is provided.[86]

An exclusion ratio is provided to prevent the taxation of that portion of payments which represents the return of amounts contributed to the plan by the employee.[87] If the amount receivable within the first three years is as great as the amount contributed by the employee, all payments received are excluded from gross income until the amount so excluded equals the amount contributed by the employee.[88] Thereafter all payments received are fully taxable. If the employee's contributions are not recoverable in three years, then their total is prorated over the payments, the proration scheme depending on the type of payment involved.[89]

Distributions payable within one taxable year of the distributee on account of an employee's death or other separation from service, or on account of his death after separation from service, are given capital gains treatment.[90] If the entire amount of the employee's account at the time of his death is paid out within the one taxable year and a later payment is made in the succeeding year as the result of a year-end contribution of the employer, the first distribution is entitled to capital gains treatment, and the subsequent payment is treated as ordinary income.[91] The survivor of an employee is entitled to the capital gains treatment even though the employee received payments prior to his death.[92]

84. INT. REV. CODE OF 1954, § 2039(c).
85. INT. REV. CODE OF 1954, § 402(a)(1).
86. INT. REV. CODE OF 1954, § 402(a)(2).
87. INT. REV. CODE OF 1954, § 72(b).
88. INT. REV. CODE OF 1954, § 72(d).
89. Treas. Reg. § 1.72-5 (1956) sets forth the methods of prorating to be applied to various kinds of payments, single life, joint-and-survivor annuity, and so forth.
90. INT. REV. CODE OF 1954, § 402(a)(2).
91. Treas. Reg. 1.402(a)-1(a)(6)(ii) (1956), as amended, T.D. 6499 1960-2 CUM. BULL. 19; Rev. Rul. 56-558, 1956-2 CUM BULL. 290.
92. Treas. Reg. § 1.403(a)-2(b)(1) (1956).

The 5,000 dollar death-benefits exclusion[93] is available to recipients. The exclusion does not apply to amounts which the employee had immediately before his death a nonforfeitable right to receive while living.[94] Obviously, from the recipient's standpoint it is desirable to show that the employee had only a forfeitable right to receive benefits before his death in order to obtain the exclusion.[95] In 1959 the IRS ruled that if an employee can withdraw his own contribution upon leaving the service of the employer, forfeiting the corporation's contributions and his right to death benefits, the exclusion is applicable.[96] A recent Tax Court case held the exclusion available because of a clause in the plan which provided that the employee's benefits would be forfeited if he were discharged for dishonesty.[97]

In the case of a total distribution within one taxable year of the distributee, to which the capital-gains provision is applicable,[98] the exclusion is available even though the employee had a nonforfeitable right to receive the benefits while living.[99] In the event the payments are made over a period of years, the 5,000 dollar exclusion is treated as a contribution of the employee, and as such excluded from the income of the beneficiary.[100]

Sections 402 and 403 of the Code were amended in 1962 to eliminate the capital-gains provision with respect to self-employed individuals;[101] however, the amount of tax payable by them on a total distribution was limited.[102] Also aimed at self-employed individuals was an amendment of the annuity provisions of section 72 to provide that the portion of contributions not deductible is to be considered as representing contributions by the employee[103] and the portion deductible, contributions by the employer.[104] Section 101 was amended too, and provides now that the 5,000 dollar exclusion for death benefits is not applicable to self-employed individuals.[105]

*Gift Tax Liability of Employee*

The Federal Gift Tax contains an exemption for the designation of a beneficiary under a qualified pension or profit-sharing plan: "The exercise or nonexercise by an employee of an election or option whereby an annuity

93. INT. REV. CODE OF 1954, § 101(b).
94. INT. REV. CODE OF 1954, § 101(b)(2)(B).
95. Treas. Reg. § 1.101-2(d) (1957).
96. Rev. Rul. 59-225, 1959-2 CUM. BULL. 36.
97. Hazel W. Pollnow, 35 T.C. 715 (1961).
98. INT. REV. CODE OF 1954, § 403(a)(2).
99. INT. REV. CODE OF 1954, § 101(b)(2)(B).
100. Rev. Rul. 58-153, 1958-1 CUM. BULL. 43.
101. INT. REV. CODE OF 1954, §§ 402-03.
102. INT. REV. CODE OF 1954, § 72(m).
103. INT. REV. CODE OF 1954, § 72(d)(2).
104. INT. REV. CODE OF 1954, § 72(m)(2).
105. INT. REV. CODE OF 1954, § 101(b)(3).

or other payment will become payable to any beneficiary at or after the employee's death shall not be considered a transfer" for gift-tax purposes.[106] Thus, if an employee makes an irrevocable election under which he would receive a lesser annuity and his wife continue to receive payments after his death, no portion of the value of the annuity is subject to the gift tax.[107] The exclusion applies only to payments attributable to contributions made by an employer: a proportionate amount of the payments is taxable for contributions made by the employee under a contributory or thrift plan.[108] Nor is the gift tax exclusion applicable to payments attributable to contributions made by a self-employed individual.[109]

*The Employer's Deduction*

Corporations may deduct from adjusted gross income contributions to a qualified pension or profit-sharing plan under section 404 of the Code if the payments satisfy the requirements of section 162 or 212.[110] There are certain limitations as to the amounts that may be deducted.[111] One of them is that contributions for self-employed individuals will not be recognized if in excess of 2,500 dollars or ten per cent of earned income, whichever is less,[112] and only one-half of the allowable contribution may be deducted.[113]

## NONQUALIFIED PLANS—GENERALLY

In determining the tax consequences of post-mortem payments from nonqualified plans, the inter vivos effects of transactions between the employer and employee during the employee's lifetime must be considered. To give the earlier transactions their proper consequences, one must keep in mind that double deductions are not intended.

*The Employer's Deduction*

The employer is entitled to a deduction for contributions to, or amounts paid under, any form of employee benefit plan if the employee's rights in the benefits are nonforfeitable at the time of the employer's contribution.[114] The practitioner working with post-mortem payments must examine the terms of the plan, and if the employee had nonforfeitable rights when the

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106. INT. REV. CODE OF 1954, § 2517(a).
107. Treas. Reg. § 25.2517-1(b)(2) (1958).
108. Treas. Reg. § 25.2517-1(c) (1958), as amended, T.D. 6666, 1963-32 INT. REV. BULL. 22.
109. INT. REV. CODE OF 1954, § 2517(b).
110. INT. REV. CODE OF 1954, § 404(a).
111. INT. REV. CODE OF 1954, § 404(a).
112. INT. REV. CODE OF 1954, § 404(e)(1).
113. INT. REV. CODE OF 1954, § 404(a)(10).
114. INT. REV. CODE OF 1954, § 404(a)(5).

employer contributed to the plan, the employer should have taken at that time the only deduction to which he is entitled. If the amount of the payments exceeds the amount of total employer-employee contributions, the excess would represent the earnings of the fund, and the employer is not entitled to a deduction for earnings.

An employee has nonforfeitable rights in a fund if there is no contingency under the plan which may cause the employee to lose his rights in the contribution.[115] According to the Treasury Regulation which provides that definition, if an employee loses the right to his annuity should his services be terminated before retirement, then his interest is forfeitable. The mere fact that an employee may not live to his retirement date, or may live for only a short period of time thereafter, and may not be able to enjoy the receipt of benefits under his plan, does not make his interest forfeitable. Thus, if the trustee of a funded trust is obligated to use the employer's contribution to provide an annuity for the employee, provided only that the employee be alive when the payments become due, the employee's rights in the contributions are nonforfeitable.

An employee may have forfeitable rights in the employer's contributions but nonforfeitable rights in his own. For example, under the terms of a contributory plan the employee might be permitted to withdraw his own contributions at any time. If an employee's interest in a plan is contingent upon his not withdrawing his own contributions, his beneficial interest in the contributions made by his employer is forfeitable.[116]

When no actual fund is set aside, the beneficiaries' rights resting upon an unsecured promise to pay, the employer will be entitled to a deduction at the time of the post-mortem payment. Previously, no payment was made for which a deduction was allowable, because only when the amounts are actually paid over to the beneficiary do the employee's rights become nonforfeitable.[117]

Conversely, if the employee's rights in a funded plan were forfeitable, the Regulations make it clear that the employer is never allowed a deduction—in the year in which the amounts are actually paid to the beneficiary or any other.[118] *Russel Mfg. Co. v. United States*[119] represents a contrary result, but the Commissioner refuses to acquiesce in that decision.[120]

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115. Treas. Reg. § 1.402(b)-1(a) (1956).
116. Rev. Rul. 59-255, 1959-2 CUM. BULL. 36.
117. Treas. Reg. § 1.404(a)(12) (1956), as amended, T.D. 6534, 1961-1 INT. REV. BULL. 145.
118. Treas. Reg. § 1.404(a)(12) (1956), as amended, T.D. 6534, 1961-1 INT. REV. BULL. 145.
119. 175 F. Supp. 159 (Ct. Cl. 1959).
120. Rev. Rul. 59-383, 1952-2 CUM. BULL. 456.

*Income Tax Liability of the Beneficiary*

Any portion of post-mortem payments to beneficiaries on which the employee paid income tax during his lifetime will not be taxed to the beneficiary. Thus, employer contributions in which the employee had nonforfeitable rights and which were required by sections 402(b) and 403(c) to be included in the employee's gross income are not taxable. Nor are any contributions of after-tax capital made by the employee taxable to the beneficiary. Payments under the plan are treated as annuities, and the tax-free amounts are considered "investments in the contract."[121] Except for those portions of the payments on which the employee has already paid income tax, post-mortem payments from nonqualified employee-benefit plans are clearly ordinary income to the beneficiary.[122]

The beneficiary is entitled to the 5,000 dollar death-benefits exclusion only if the employee did not possess, immediately before his death, a nonforfeitable right to receive the payments, or some part of them, while living.[123] It should be pointed out that the employee's right to receive payments while living can be made forfeitable or nonforfeitable with comparative ease. The Tax Court held that an employee's rights were forfeitable under a plan which provided that he could be fired and would lose his rights under the plan for conduct constituting a felony or misdemeanor involving moral turpitude, or for willful disloyalty to his employer.[124]

The question of whether the employee had "nonforfeitable rights to receive the amounts while living" is closely associated with a determination of whether or not post-mortem payments from employee-benefit plans are income in respect of a decedent, falling under section 691. If the payments are of that character the 5,000 dollar death-benefits exclusion does not apply, because the Code provides that income in respect of a decedent maintains the same character in the hands of the recipient as it had in the hands of the decedent, who was, of course, not entitled to the 5,000 dollar exclusion.[125] Instead, the recipient is entitled to a deduction for the amount of his tax attributable to that income, or the amount by which the decedent's estate tax was increased by reason of the inclusion in the decedent's gross estate of the benefits as income in respect of a decedent.[126] While Congress has not defined "income in respect of a decedent," the Treasury Regulations state that the term encompasses income to which a decedent was entitled

121. Treas. Reg. § 1.72-8(a) (1956), as amended, T.D. 6665, 1962-32 INT. REV. BULL. 7.
122. INT. REV. CODE OF 1954, §§ 61, 101(b), 402, 403.
123. INT. REV. CODE OF 1954, § 101(b)(2)(B).
124. Hazel C. Pollnow, 35 T.C. 715 (1961).
125. INT. REV. CODE OF 1954, § 691; Treas. Reg. § 1.691(a)-3 (1957).
126. INT. REV. CODE OF 1954, § 609(c).

and which would have been included in his gross income, but which was not properly includable in his last taxable year.[127] Some authorities are of the opinion that payments from employee benefit plans are income in respect of a decedent to the extent of the employee's nonforfeitable rights in the plan.[128] Only two cases have considered the question; they are in direct conflict. The Court of Appeals for the Third Circuit in *Hess v. Commissioner*[129] held that such payments were income in respect of a decedent while a California district court in *Lacomble v. United States*[130] held that they were not.

Another issue related to the forfeitability of the decedent's rights was the question of whether the doctrine of constructive receipt applied to payments under unfunded plans. In the past, tax practitioners were hesitant to allow an employee to have nonforfeitable rights in an unfunded plan, so that the employee would not be held to have constructively received the sums promised as death benefits. Constructive receipt would have meant their inclusion in the employee's gross income;[131] and "return of capital," or the "investment in the contract concept," would then require the tax-free receipt by the beneficiary of any amounts which had already been taxed.

In 1960 a Revenue Ruling eliminated this issue by making it clear that the doctrine of constructive receipt does not apply to the unfunded-plan situation.[132] A mere promise to pay, which is not secured in any way, will not be regarded as a receipt of income for one employing the cash receipts and disbursements method of accounting.[133] (The ruling is specifically limited to that method.) The Treasury's reasoning is as follows: Section 402(b), which provides for income tax consequences to the employee in the year of employer contribution when the employee's rights in the contribution are nonforfeitable, applies only to funded trusts. Since no trusts or contributions thereto are involved in unfunded plans, the tax consequences of section 402 do not apply. The ruling concludes with an example of a deferred compensation plan for executives, stating that additional compensation to be received by a taxpayer under a contract will be included in his gross income only for the taxable year in which he actually receives the payments previously only credited to his account.[134]

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127. Treas. Reg. § 1.691(a)-1(b) (1957).

128. *E.g.*, CCH 1963-1 STAND. FED. TAX REP. ¶¶ 916.003, 916.006.

129. 271 F.2d 104 (3d Cir. 1959).

130. 177 F. Supp. 373 (D. Cal. 1959).

131. See Treas. Reg. § 1.446-1(d)(i) (1957), as amended, T.D. 6584, 1962-1 INT. REV. BULL. 67; Treas. Reg. § 1.451-1(a) (1957).

132. Rev. Rul. 60-31, 1960-1 CUM. BULL. 174.

133. Rev. Rul. 60-31, 1960-1 CUM. BULL. 174.

134. Rev. Rul. 60-31, 1960-1 CUM. BULL. 180.

*Tax Liability of Decedent's Estate*

The actuarily-computed present value of a beneficiary's right to receive payments under nonqualified plans is normally included in the deceased employee's gross estate.[135] The Code provides that included in the gross estate shall be

> the value of an annuity *or other payment* receivable by any beneciary by reason of surviving the decedent under any form of contract or agreement, . . . *if* under such contract or agreement, an annuity or other payment was payable to the decedent, or the decedent possessed the right to receive such annuity or payment, either alone or in conjunction with another for his life or for any period not ascertainable without reference to his death, or for any period which does not in fact end before his death.[136]

Note the necessity of some inter vivos character to the benefit payments; absent this feature the payments escape inclusion in the gross estate.

The language "annuity or other payment" refers to "one or more payments extending over any period of time," whether the payments are "equal or unequal, conditional or unconditional, periodic or sporadic."[137] The phrase " 'contract or agreement' includes any arrangement, understanding or plan, or any combination of arrangements, understandings or plans arising by reason of the decedent's employment."[138] With respect to the necessary inter vivos character of the payment, the "annuity or other payment 'was payable' to the decedent if, at the time of his death, the decedent was in fact receiving an annuity or other payment, whether or not he had an enforceable right to have the payments continued."[139] "The decedent 'possessed the right to receive' " the payment "if, immediately before his death, he had an enforceable right to receive payments at some time in the future," whether or not he had a present right to receive them at the time of his death.[140] An enforceable right to receive payments at some time in the future exists if the deceased employee had complied with his obligations under his agreement with the employer up to the time of his death.[141]

The only nonqualified payments excluded from the gross estate are those

135. INT. REV. CODE OF 1954, § 2039.

136. INT. REV. CODE OF 1954, § 2039(a). (Emphasis added.)

137. Treas. Reg. § 20.2039-1(b) (1958), as amended, T.D. 6666, 1963-32 INT. REV. BULL. 22.

138. Treas. Reg. § 20.2039-1(b) (1958), as amended, T.D. 6666, 1963-32 INT. REV. BULL. 22.

139. Treas. Reg. § 20.2039-1(b) (1958), as amended, T.D. 6666, 1963-32 INT. REV. BULL. 22.

140. Treas. Reg. § 20.2039-1(b) (1958), as amended, T.D. 6666, 1963-32 INT. REV. BULL. 22.

141. Treas. Reg. § 20.2039-1(b) (1958), as amended, T.D. 6666, 1963-32 INT. REV. BULL.

under contracts expressly providing that no payments will ever be made to the employee, all accrued benefits going to a beneficiary after the employee's death. The essential inter vivos character is absent, and the value of the payments is not includable under section 2039. The courts have so held although their reasoning differs somewhat.[142] One writer has reached the interesting conclusion that survivor benefits under nonqualified plans are includable in the gross estate under section 2033 as property in which the decedent had an interest.[143] The Commissioner has not yet availed himself of this argument.[144] The view does not seem logical: To be includable in the decedent's gross estate under section 2033 property must be "beneficially owned" by the decedent at the time of his death.[145] It is doubtful that the decedent can be said to beneficially own the right to have post-mortem payments made to his beneficiary even though the right is, of course, of some benefit to him.

*Gift Tax Consequences Under Nonqualified Plans*

Ordinarily there are no gift tax consequences attaching to arrangements involving nonqualified employee benefit plans; the "transfer," or naming of beneficiary, is almost always incomplete and therefore the transaction is not taxable as a gift. The one instance in which gift tax consequences do arise occurs when an employee with nonforfeitable rights under a nonqualified plan exercises an irrevocable election to make the benefits payable to a particular beneficiary.[146] The Regulations give as an example an employee with a nonforfeitable right to receive an annuity, who elects to take a reduced annuity upon the condition that a similar reduced annuity will be paid to a given beneficiary; the employee has given up his power to deprive the beneficiary of the promised payment.[147]

## SPECIFIC NONQUALIFIED PLANS AND THEIR CONSEQUENCES

The preceding discussion has been general in nature. With this background, it is possible to examine the particular effects of some of the more commonly employed nonqualified benefit plans and their methods of granting benefits.

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142. See McCobb v. All, 62-2 U.S. Tax Cas. ¶ 12096 (D. Conn. 1962); Estate of Bahen v. United States, 62-2 U.S. Tax Cas. ¶ 12091 (Ct. Cl. 1962); Wadewitz v. Commissioner, 39 T.C. 925 (1963); Whitworth v. Commissioner, 22 CCH Tax Ct. Mem. 177 (1963); see also Zissman, *Problem Areas in the Estate Tax*, 41 TAXES 885 (1963).

143. *Gordon*, TUL. TAX INST. 593.

144. See Estate of Bahen v. United States, 62-2 U.S. Tax Cas. ¶ 12091 (Ct. Cl. 1962).

145. Treas. Reg. § 20.2033-1(a) (1958), as amended, T.D. 6684, 1963-46, INT. REV. BULL. 19.

146. Treas. Reg. § 25.2511-1(h)(10) (1958).

147. Treas. Reg. § 25.2511-1(h)(10) (1958).

*The Use of Funded Trusts*

Frequently an employer will create a funded trust to carry out the terms of a pension or profit-sharing plan. Usually the payments therefrom are taxable as income to the beneficiary.[148] They are taxable to the extent that the contributions of the employer were taxable when made and to the extent of the employee's contributions. If the investment in the contract concept applies, amounts included in the gross income of the employee during his life are excluded. If the contributions by the corporation are put in a trust to fund the contract but are still forfeitable the employee is not taxed at the time of the contribution.[149]

Payments from funded trusts are taxed as annuities, and the 5,000 dollar death-benefits exclusion cannot be taken all at one time. That amount becomes a portion of the investment in the contract, and a proportion of each payment determined under the familiar annuity rules constitutes tax-free income to the beneficiary.[150]

*Deferred Compensation Plans*

The IRS treats any nonqualified employee benefit plan which is not a pension or profit-sharing plan as a "deferred compensation plan";[151] however, in the present discussion the term is restricted to the most common deferred compensation arrangement—present salary payments deferred to a later year. In furtherance of this type of plan the employer will often purchase an endowment life insurance policy or retirement annuity contract to guarantee funds to carry out his unsecured obligation to pay.[152]

The availability of a deduction to the employer, the income tax consequences to the beneficiary, and the gift tax consequences to the employee in the case of deferred compensation plans are what one could expect in light of the earlier general treatment of the effects of distributions from post-mortem plans. For example, the employer is entitled to a deduction for the payments only when the beneficiary actually receives them, because only then do they become nonforfeitable.[153]

There are some interesting problems in connection with includability in the decedent's gross estate. Under principles previously discussed, the value of the right to payments under deferred compensation agreements is included

148. See INT. REV. CODE OF 1954, §§ 61, 101(b), 402-03.

149. INT. REV. CODE OF 1954, § 101(b). If contributions are forfeitable, section 402(b) does not apply. Doty v. United States, 63-2 U.S. Tax Cas. ¶ 9761 (6th Cir. 1963).

150. Treas. Reg. § 1.72-8(b) (1956), as amended, T.D. 6665, 1962-33 INT. REV. BULL. 7.

151. See INT. REV. CODE OF 1954, §§ 401-04, referring *passim* to "any plan deferring the receipt of compensation."

152. 1961 So. CAL. TAX INST. 325.

153. INT. REV. CODE OF 1954, § 404(a)(5); Treas. Reg. § 1.404(a)(12) (1956).

in the decedent's gross estate if the decedent would have been entitled to inter vivos payments had he lived long enough. In some cases, however, certain inter vivos aspects exist, although the employee would never be entitled to inter vivos payments under any circumstances. These aspects may be sufficient to cause the payments to be included in the gross estate of the decedent. Probably the value of payments to a beneficiary must be included in the decedent's gross estate if the employee possessed during his lifetime the power to change the beneficiary or to affect the time or manner of the beneficiary's enjoyment of the payments.[154] In *McCobb v. All*[155] and *Estate of Bahen v. United States*[156] death benefit payments were included in the gross estates of deceased employees, because the payments were incorporated into plans including other payments which might have been received by the decedents had they lived long enough; the payments in question were part of plans with a "lifetime aspect."

In both *McCobb* and *Bahen* the employees had no voice in determining the agreement under which the post-mortem payments would be made, and could not themselves have received the payments under any circumstances. If the employee *is* given a voice in determining the original arrangement, the following situation could occur: The employer could deliberately create a situation in which he possessed no right to change the beneficiary, or the time or manner of enjoyment, and no right to receive inter vivos payments. Then later if it suited his purposes he might negotiate for and obtain one of these rights. In *Whitworth v. Commissioner*[157] payments became due under an individual agreement negotiated between the employer and the deceased employee; the value of that payment, however, was excluded from the decedent's gross estate, because under the terms of the agreement involved the designation of the beneficiary was irrevocable. If the *Whitworth* case is correct, then the fact that the employee had some voice in making the agreement will not automatically render payments to beneficiaries pursuant thereto includable in the deceased employee's gross estate. Nonetheless, it can be argued with some force that a distinction should be drawn between a situation where an employer has a plan which is applicable to all employees of a particular class and a situation in which a contract of employment calling for the death benefits is negotiated individually by the employer with an employee. It will be recalled that the Treasury Regulations promulgated for section 2033 included within the decedent's estate all property "beneficially owned" by him at death. That language might be applied to payments which

154. See INT. REV. CODE OF 1954, § 2038.
155. 62-2 U.S. Tax Cas. ¶ 12096 (D. Conn. 1962).
156. 62-2 U.S. Tax Cas. ¶ 12091 (Ct. Cl. 1962).
157. 22 CCH Tax Ct. Mem. 41 (1963).

become due under a contract negotiated by an individual employee. Intimations along these lines are found in the *Bahen* case.

*Plans Calling for Payments From Current Earnings*

The employer may defer the payment of part of an employee's compensation until a later year and make the amount then payable depend upon current earnings in that year. For example, the employer could agree to allocate to the employee's account a certain percentage of the employer's earnings during the years of employment. Obviously, these agreements might reflect many variations. The plan could be funded with an agreed portion of the earnings for various years used to fund the plan. More frequently there will be merely an unsecured promise to pay. The principles previously discussed apply to these plans. If there is merely an unsecured promise to pay, the employer is only entitled to his deduction when the payments are actually made, because only then do rights in the payments become nonforfeitable. Similarly, the payments would be taxable as ordinary income to the beneficiary in the year received, and the 5,000 dollar death benefit exclusion will inure to the beneficiary unless the payments are considered income in respect of a decedent. Includability of payments in the gross estate of the deceased employee will depend on whether inter vivos aspects are present; if the employee had any of the inter vivos "ownership" attributes contemplated by sections 2038 or 2039, as would be the case, for example, if the payments were "joint and survivor" with regard to the employee and his spouse, the value of the payments will be included in decedent's gross estate. For the most part, the only innovation introduced by this type of plan is the factor that the amounts to be treated as deferred compensation depend upon the employer's profits.

With regard to gift tax consequences, an issue peculiar to arrangements calling for the payment of undetermined amounts may be present. As noted earlier there is one instance in which payments from nonqualified plans may be subject to the gift tax: when an employee exercises an irrevocable option to have the payments made to a particular beneficiary. With regard to plans calling for payments from current earnings a problem may arise because of the uncertainty as to the amounts which will be paid under the plan. It might be very difficult, if not impossible, to value the gift under the Treasury's rule that "the value of the property is the price at which such property would change hands between a willing buyer and a willing seller."[158]

*Other Nonqualified Plans*

There are a few other schemes sufficiently common to bear mention. "Contractual bonus" plans obligate the employer by contract to pay a bonus

158. Treas. Reg. § 2512-1 (1958).

to the employee or successors of the employee. The distinguishing feature of this type of plan would be that the amounts paid should depend primarily upon the results of the employee's efforts. No problems peculiar to this type of plan are apparent.

"Salary continuation" refers to the arrangement whereby the employer continues the decedent's salary to his widow or some other beneficiary for a limited period of time. A contractual obligation to make the payments might be present or only the employer's customary practice of making such payments.[159] Here again, no special problems should occur.

159. Rev. Rul. 62-102, 1962 INT. REV. BULL. 28, at 7. As to continuation payments to widows generally, see Pelisek, *Conflict in Widow's Cases Continues as Supreme Court Denies Certiorari*, 17 J. TAXATION, 118 (1963).